No. 10,206 /3

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA, *Appellant,*	
vs.	
DON LEE, INC., *Appellee.*	

On Appeal from the District Court of the United States for the Northern District of California, Southern Division.

BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

OPINION BELOW.

The memorandum opinion of the District Court (R. 16-21) is reported in 42 F. Supp. 884.

JURISDICTION.

This is an action for the recovery of income and excess profits taxes paid. The complaint, filed May 7, 1941 (R. 2-7), alleges that the taxes were illegally exacted and that the claims for refund, filed June 26, 1940, were rejected on January 25, 1941 (R. 6); also, that the action is instituted under the revenue laws of

the United States (R. 2). While the complaint does not refer specifically to the statutory provision believed to sustain jurisdiction, it is assumed that the jurisdiction of the District Court was invoked under Section 24 (20) of the Judicial Code, as amended. The case is brought to this Court by notice of appeal filed May 27, 1942 (R. 24), from the judgment of the District Court entered March 30, 1942 (R. 23). The jurisdiction of this Court rests upon Section 128 (a) of the Judicial Code, as amended.

QUESTION PRESENTED.

Whether, in computing depreciation for the years 1935 and 1936 under Sections 23, 113 and 114 of the Revenue Acts of 1934 and 1936, the taxpayer's basis should be reduced by the amount deducted for depreciation in prior years (1931 to 1933, inclusive) in excess of that properly allowable where the excess was not offset by taxable income for those years.

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in

the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b)

for the purpose of determining the gain upon the sale or other disposition of such property.

Sections 23 (l) and (n), 113 (b) (1) (B) and 114 (a) of the Revenue Act of 1936 contain the same provisions as those of the Revenue Act of 1934, above quoted.

The applicable regulations are Articles 23 (l)-1, 2, 4, 5 and 9, 113 (b)-1 and 114-1 of Treasury Regulations 86 and 94, relating to the Revenue Acts of 1934 and 1936.

STATEMENT.

Pursuant to stipulation (R. 15), the case was submitted to the District Court for decision upon the stipulation of facts and the pleadings (R. 21). Thereafter briefs were filed and the court made special findings of fact and conclusions of law (R. 22) and gave judgment for the taxpayer in the principal sum of $1,637.77 (R. 23) from which judgment this appeal has been taken.

The following facts were stipulated (R. 10-14) and found by the District Court (R. 22):

The taxpayer, Don Lee, Inc., at all times hereinafter mentioned, was a corporation organized under the laws of California, with an office in San Francisco. (R. 11.)

The taxpayer, on or about January 1, 1931, was the owner of depreciable machinery, equipment, furniture and fixtures, subject to depreciation allowance, which

cost $292,301.22 and which, after deducting depreciation of $183,410.43, had a book value as of January 1, 1931, of $108,890.79. The taxpayer on its books of account computed depreciation on the basis of a ten-year life from the date of acquisition of the properties. In filing its income tax returns for the years 1931, 1932, 1933, 1934, 1935 and 1936, the taxpayer reported a deduction of depreciation on the same basis. (R. 11.)

On March 14, 1936, the taxpayer filed its income tax return for the calendar year 1935 showing its gross income and deductions, among which was an item of depreciation in the amount of $40,271.08, and a net income on which income and excess profit taxes of $32,454.83 were payable, and which were paid in quarterly installments in 1936. (R. 11-12.)

Thereafter, the Commissioner of Internal Revenue determined that the depreciation allowable to the taxpayer for the year 1935 was not $40,271.08, as reported, but was $34,399.97. This, and other adjustments not in dispute, increased the net income and made an additional tax due. A notice of deficiency in income and excess profits tax of $3,808.50, interest $517.91, a total of $4,326.41, was duly given, which was paid on July 12, 1938. (R. 12.)

On March 15, 1937, the taxpayer filed its income tax return for the calendar year 1936 showing gross income and deductions, among which was an item of depreciation in the amount of $37,816.58, and a net income on which an income tax of $59,695.16 was due, which was paid in quarterly installments in 1937. (R. 12.)

Thereafter, upon facts coming to his attention, the Commissioner made adjustments (not now in dispute) which increased the net income and resulted in a deficiency in income tax of $757.64. This deficiency was paid on July 12, 1938, by the taxpayer, together with interest amounting to $57.57, or a total amount of $815.21. Thereafter, the taxpayer filed its claim for refund for 1936, in which taxpayer claimed that additional depreciation for 1936 ought to be allowed amounting to $3,730.55. (R. 12.)

The dispute as to allowable depreciation resulted from a determination by the Commissioner made in June, 1938, that certain property upon which depreciation was taken by the taxpayer had a normal and useful life of 15 years from date of acquisition, and that the depreciation allowable thereafter should be computed on that basis and not on the basis of a life of 10 years. (R. 12-13.)

The taxpayer filed its claim for refund of tax and interest for the years 1935 and 1936 on June 27, 1940. These claims were based on the ground that the life of the assets in question was 15 years from date of acquisition, and that since taxpayer sustained operating losses for the years 1931, 1932 and 1933, depreciation for those years should be adjusted on the basis of a normal useful life of 15 years from date of acquisition, and that if depreciation for those years were so adjusted, the book value of the assets as of January 1, 1934, would be increased and a larger amount of depreciation for 1935 and 1936 would be allowable. The claims for refund were rejected on May 10, 1941. No

part of the tax and interest in dispute herein has been refunded to the taxpayer. The taxpayer sustained operating losses during the years 1931, 1932 and 1933 which, in fact, exceeded the depreciation reported. (R. 13.)

Allowance for depreciation for the years 1935 and 1936 upon the basis of a 15-year useful life from the date of acquisition is correct. (R. 13.)

The parties stipulated that if taxpayer's contention is correct, and the book value of the properties as of January 1, 1934, should be increased by the amount of excessive depreciation reported for the income tax returns for 1931, 1932 and 1933, then the allowable depreciation for 1935 should be increased by $4,694.04, and the taxpayer has overpaid its income tax for 1935 in the amount of $880.13; and the allowable depreciation for 1936 should be increased by $3,730.55. Taxpayer's overpayment of income tax for 1936, if the allowable depreciation is so increased, would amount to $1,209.63, of which $757.64, with interest, was paid on July 11, 1938. The statute of limitations has run on recovery of sums paid prior to July 11, 1938, in so far as the 1936 tax is concerned. (R. 14.)

As stated above, the District Court gave judgment for the taxpayer and the United States took this appeal.

STATEMENT OF POINTS TO BE URGED.

The District Court erred:

1. In not holding that the taxpayer's basis to be recovered at the new depreciation rates is cost less depreciation deducted on previous returns which were accepted by the Commissioner, even though depreciation in those returns was excessive and the excess was not offset by taxable income.

2. In entering judgment for the taxpayer.

SUMMARY OF ARGUMENT.

The decision of the District Court is plainly unsound. Sections 114 (a) and 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936 provide that in determining the basis for depreciation, proper adjustment shall be made in respect of earlier years, for depreciation, to the extent allowed (but not less than the amount allowable) under the Act or prior income tax laws. The decision below would confine the adjustments to the amount allowable even though the taxpayer actually claimed more as deductions in prior years and the Commissioner did not oppose. That result is contrary to the statute. It is immaterial whether the amounts in question were offset by taxable income, for the statute does not depend for its operation upon considerations of whether the taxpayer derived any tax advantage from the deductions in prior years.

ARGUMENT.

THE TAXPAYER'S BASIS SHOULD BE REDUCED BY THE ENTIRE AMOUNT OF DEPRECIATION CLAIMED AND ALLOWED FOR PRIOR YEARS.

Section 114 (a) of the Revenue Acts of 1934 and 1936, *supra,* provides that the basis for depreciation shall be the adjusted basis provided in Section 113 (b), *supra,* for the purpose of determining the gain upon sale or other disposition of the property. Section 113 (b) (1) (B) provides that in determining such basis, proper adjustment shall be made in respect of any period since February 28, 1913, for depreciation, to the extent allowed (but not less than the amount allowable) under the Act or prior income tax laws. It is our view that depreciation is allowed within the meaning of the statute when it is claimed by the taxpayer and not opposed by the Commissioner, even though the taxpayer has no net income which is offset thereby. We find nothing in the statute or regulations, *supra,* which supports the conclusion that a deduction can be treated as allowed only when it results in a tax advantage to the taxpayer. And in *Helvering v. State-Planters Bank & Trust Co.,* 130 F. 2d 44 (C.C.A. 4th), the court, approving G.C.M. 22,163, 1940-2 Cum. Bull. 76, held that amounts recovered in any taxable year upon debts previously charged off and allowed as a deduction should be treated as taxable income regardless of whether the prior allowance of the deduction resulted in a tax benefit to the taxpayer. That case certainly supports our position here and it has been followed by the Third Circuit in *Commissioner v.*

United States & International Securities Corp. (C.C. A. 3d), decided September 24, 1942 (1942 C.C.H., par. 9667). To the same effect see *Stearns Coal & Lumber Co. v. Glenn,* 42 F. Supp. 28 (W.D. Ky.), appeal to the Circuit Court of Appeals for the Sixth Circuit pending. Cf. also *National Bank of Commerce v. Commissioner,* 115 F. 2d 875 (C.C.A. 9th).

It is true that in *Pittsburgh Brewing Co. v. Commissioner,* 107 F. 2d 155 (C.C.A. 3d), the court took the view that depreciation is not allowed within the meaning of the statute[1] unless it is actually taken as a deduction against taxable income and that case was followed by the court below[2] but it is believed to be unsound and in substantial conflict with the *State-Planters Bank & Trust Co.* and *International Securities Corp.* cases, *supra.* See also *Beckridge Corp. v. Commissioner,* 129 F. 2d 318 (C.C.A. 2d). Attention is also invited to a note in 40 Columbia Law Review 540, where it is concluded that the *Pittsburgh Brewing Co.* case was erroneously decided.

Prior to the 1924 Act, there was no specific provision with respect to adjustment for depreciation in computing gain or loss from a sale of property, but the courts nevertheless held that the basis should be

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[1]The statute there involved, Section 113 (b) (1) (B) of the Revenue Act of 1932, contains the same provisions as Section 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936, here involved.

[2]The *Pittsburgh Brewing Co.* case was also followed in *Kennedy Laundry Co. v. Commissioner,* 46 B.T.A. 70, appeal to the Circuit Court of Appeals for the Seventh Circuit pending, and in *Virginian Hotel Corp. v. Commissioner,* decided May 6, 1942 (Prentice Hall B.T.A. Service, par. 42,268), appeal to the Circuit Court of Appeals for the Fourth Circuit pending.

reduced by the amount which was legally allowable in past years even though no such deduction was taken and no tax advantage would have resulted if it had been taken. *United States v. Ludey,* 274 U. S. 295; *Hardwick Realty Co. v. Commissioner,* 29 F. 2d 498 (C.C.A. 2d). The theory underlying these cases is that by using up property, a gradual sale is made of it. When the property is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale. See *United States v. Ludey, supra,* p. 301. By Section 202 (b) of the Revenue Act of 1924, it was provided that in computing gain or loss, adjustment should be made for depreciation previously allowed. Section 202 (b) of the Revenue Act of 1926 is somewhat different; it provides for diminution of the basis by the amount of the deductions for depreciation which have since the acquisition of the property been allowable. That provision is also contained in Section 111 (b) (2) of the Revenue Act of 1928. In Section 113 (b) (1) (B) of the Revenue Act of 1932, the law was again changed so as to provide for adjustment for depreciation to the extent allowed (but not less than the amount allowable) under that Act or prior income tax laws. As hereinbefore noted, the same provision is contained in Section 113 (b) (1) (B) of the Revenue Acts of 1934 and 1936, here involved.[3] The reason for the 1932 change was to prevent a taxpayer who had

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[3]All of these Revenue Acts from 1924 to 1936 have provided generally that the same basis shall be used for depreciation as for gain or loss. See Section 204 (c), Revenue Acts of 1924 and 1926, Section 114 (a), Revenue Acts of 1928, 1932, 1934 and 1936.

taken depreciation deductions over a period of years from claiming in a subsequent year that such deductions were excessive and that his basis should be reduced only by a lesser amount which was properly allowable.[4] If a taxpayer could do this, then he might obtain a double deduction which was not intended by Congress. But surely it does not follow that Congress meant to limit the adjustment to the amount actually deducted from taxable income. Clearly, the statute provides for adjustment in respect of the amount allowable, where that is greater than the amount al-

[4]See S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 496, 517), as follows:

> In subparagraph (B), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made "to the extent allowed (but not less than the amount allowable)" instead of "by the amount * * * allowable" as in the prior act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact "allowable" were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very large upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility. Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayer in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made.

lowed, even though no deduction was ever claimed. *Beckridge Corp. v. Commissioner, supra; Herder v. Helvering,* 106 F. 2d 153 (App. D.C.), certiorari denied, 308 U. S. 617. And where, as here, the amount actually taken as deductions exceeds that properly allowable, then under the statute, the first amount must be used as the adjusting figure regardless of whether such deductions resulted in any tax advantage to the taxpayer. The statute is plain and unqualified and in the absence of an express provision to the contrary, we submit that it should be interpreted in conformity with the rule that a deduction is none the less allowed even though it results in no tax advantage to the taxpayer. *Helvering v. State-Planters Bank & Trust Co., supra.* Each taxable year must be regarded as an independent unit for income tax purposes (*Burnet v. Sanford & Brooks Co.,* 282 U. S. 359; *Burnet v. Thompson Oil & G. Co.,* 283 U. S. 301, 306), and it would be contrary to the spirit of that rule to permit a taxpayer to reduce his income for one year merely because he derived no tax advantage from a deduction taken in a previous year.

Moreover, it is erroneous to assume that a taxpayer derives no tax advantage from any particular deduction merely because he has no net income for the year in question. So long as he has some gross income, it can not be said that the deduction did not contribute to some extent at least in offsetting that income. In the instant case the taxpayer sustained losses in the years 1931-1933 during which it reported depreciation in excess of the amount properly allowable. But we submit that this is not sufficient to compel the conclusion that the depreciation deductions resulted in no

tax advantage for those years. See dissenting opinion of Member Disney in *Kennedy Laundry Co. v. Commissioner*, 46 B.T.A. 70, *supra*. The record does not contain the tax returns and we submit that the taxpayer has failed to sustain the burden of proving the absence of tax advantage, even if that should be considered material Cf. *Burnet v. Houston*, 283 U. S. 223.

Furthermore, there would be administrative difficulties in applying the rule approved by the court below. See *Helvering v. State-Planters Bank & Trust Co., supra,* where in an analogous situation the court said (p. 48):

> To apply the rule contended for by taxpayer would, we think, result in great confusion and complication in this particular branch of the tax law. What would be the rule where the charge off has resulted in tax benefit only to the extent of a portion of the debt? What, where other deductions are involved which, together with the deduction of the debt, result in no taxable income? What of the situation where, because of difference in tax rate, the tax benefit from the deduction does not equal the amount of the tax arising from the collection? The rule which we think is the correct one presents no such difficulties and is logically unassailable. The taxpayer is bound by the election which he has made in charging the debt off and deducting it as worthless in his return. There is no occasion to inquire whether this has resulted in tax benefit, for the matter under consideration is the income of a subsequent year.

Where a taxpayer has gross income and the depreciation item is only one of several items comprising

the total deductions which were taken into consideration in determining a net loss, it is difficult to see any ground for concluding that the depreciation resulted in no tax advantage, unless it be to the small fractional extent resulting from apportioning net loss in the ratio of depreciation to total deductions. See dissenting opinion of Member Disney in *Kennedy Laundry Co.* case, *supra.*

In the light of these considerations, we submit that there is no occasion to inquire whether the deductions in question resulted in tax benefit. They were claimed by the taxpayer, allowed by the Commissioner and under the specific language of the statute, the amount thereof should be applied against the basis for future depreciation deductions.

CONCLUSION.

The judgment of the court below should be reversed.

Dated, November 6, 1942.

Respectfully submitted,

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